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No. 175

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CHARLES ELMORE CROPLE
CLERK

IN THE
Supreme Court of the United States

ECCO HIGH FREQUENCY CORPORATION,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO CIRCUIT COURT OF
APPEALS FOR THE SECOND CIRCUIT.

PETITION AND BRIEF FOR PETITIONER.

The Firm of
MR. AND MRS. EVERETT FROOKS,
Attorneys for Petitioner,
30 Vesey Street,
Borough of Manhattan,
City and State of New York.

✓
EVERETT FROOKS,
JOSEPH P. DOWLING,
MARGARET FROOKS,
Of Counsel.

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IN THE
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ECCO HIGH FREQUENCY CORPORATION,
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v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION.

*To the Honorable Chief Justice and the
Associate Justices of the United States:*

The petitioner, a corporation organized and existing under the laws of the State of New York, and having its principal office at #7020 Hudson Boulevard, North Bergen, New Jersey, by its attorney Everett Frooks, respectfully seeks a review of a judgment of the Circuit Court of Appeals for the Second Circuit, made on the 27th day of April, 1948, affirming a determination of the Tax Court, dated September 24th, 1947, with respect to alleged tax deficiencies of the petitioner for the tax year 1941.

Jurisdiction.

The petitioner relies upon 28 U. S. C. A. 347 (Judicial Code 240, as amended) as conferring jurisdiction upon this Court to entertain present application.

Not more than three months has elapsed from the date of the judgment of the Circuit Court of Appeals to the date of the judgment of the Circuit Court of Appeals to the date of the making of the application.

Opinions Below.

The opinion of Tax Court appears at page 20, *et seq.*, of the record.

The opinion of the Honorable August N. Hand, Circuit Judge, which is reported in 167 F. 2d 583, appears at page 94, of the record.

Statement of Matter Involved.

The petitioner, which is a manufacturer of high frequency industrial heating equipment, paid to Emil R. Capita, for services rendered during the tax year in question, the sum of \$56,000. The said Capita was the petitioner's only salaried officer and his principal work was in the highly specialized capacity of "sales engineer". Of the amount so paid the Commissioner of Internal Revenue allowed only \$25,000 as reasonable compensation for the services in question. The Tax Court allowed \$40,000 and the Circuit Court of Appeals has affirmed that allowance. It is the judgment of affirmance by the Circuit Court of Appeals which is sought to be reviewed herein.

The uncontroverted evidence shows that the amount paid for the services rendered which is computed on the basis of a computation of 30% of petitioner's gross sales for the year in question is less than the amount paid by the petitioner's competitors for comparable services, who paid commissions approximating 40% of the gross sales. The Tax Court found that such percentages were a custom of the industry.

The action of the Tax Court in allowing a lesser amount is without foundation in the record.

The Circuit Court of Appeals erred in failing to subject the determination of the Tax Court to a proper review

which would have revealed the fatal defect of foundation for the determination of the Tax Court on the question of reasonable compensation.

Questions Presented.

The petitioner desires to bring up for review by this Court the following questions:

I. Whether the Circuit Court of Appeals has erroneously abdicated its power of review over the Tax Court and thereby deprived the petitioner of substantial rights.

II. Whether Sec. 10 (e) of the Administrative Procedures Act gives the Circuit Court of Appeals a broader power of review than that theretofore existing under the *Dobson* rule and whether in view of such expanded power the Circuit Court of Appeals has in error failed to review the whole record of this case and whether the apparent conflict existing between the Second and Sixth Circuits in this regard should not be clarified.

III. Whether the recent amendment to Sec. 1141 (a) of the Internal Revenue Code entitles petitioner to a broader review by the Circuit Court of Appeals.

IV. Whether these assessments constitute confiscation of petitioner's property.

Reasons for Granting Writ of Certiorari.

It is respectfully submitted that the questions here presented are of substantial general concern. The holding below reveals anew an unwarranted reluctance on the part of the Circuit Court of Appeals to disturb findings of the Tax Court, even though unsupported by substantial evidence.

Statute and Regulations Involved.

Section 23(a) (1) (A) of the Internal Revenue Code provides as follows:

“ (a) Expenses.

“ (1) Trade or business expenses.

“ (A) In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

Regulations 103, Sec. 19.23(a)-6 provide in part as follows:

“Compensation for Personal Services. — Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

“ (2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on

the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

“(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.”

Petitioner's attorney believes that the petitioner has good and meritorious grounds for this application.

WHEREFORE, the petitioner respectfully prays this Court for a Writ of Certiorari to the Circuit Court of Appeals of the United States of the Second Circuit in order to bring up for review thereto the questions herein presented.

EVERETT FROOKS.



IN THE

Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF FOR PETITIONER.

ON PETITION FOR WRIT OF CERTIORARI TO CIRCUIT COURT OF APPEALS
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Opinions Below.

The opinion of Tax Court which is reported in _____, appears at page 20 et seqq. of the record.

The opinion of the Honorable August N. Hand, Circuit Judge, which is reported in 167 F. 2nd 583, appears at page 94, of the record.

Jurisdiction.

The jurisdiction of this Court is invoked under 28 U. S. C. A. 347 (Judicial Code, Sec. 240, as amended).

Statement of Proceedings.

This case involves a petition to review a judgment of the Circuit Court of Appeals made on April 27, 1948, which judgment affirms an order of the Tax Court heretofore

made herein on September 24, 1946, determining deficiencies against the petitioner for the year 1941, in income tax, declared value excess profits taxes and excess profits tax of \$4,237.57, \$2,424.18 and \$6,309.95, respectively.

Facts.

The issues between the petitioner and the Commissioner, insofar as material to this application, revolve about a payment made by the petitioner to Emil R. Capita, for services rendered during the taxable year in question. The Commissioner originally allowed \$25,000 out of a payment of \$56,000 made to the said Capita. The Tax Court allowed \$40,000 as reasonable and the Circuit Court of Appeals has affirmed that determination.

The said Emil R. Capita was the only salaried officer of the petitioner. His principal work, however, was in the highly specialized capacity of sales engineer. The Tax Court found that it was a trade custom to pay 40% of gross sales as commissions to sales engineers on sales of high frequency equipment in New York City, and slightly more on sales outside that area. The amount paid to Capita was based on a computation of 30% of sales and was subsequently reduced to \$56,000.

The Tax Court, in face of its own finding as to the custom, arbitrarily fixes \$40,000 as the reasonable value of the services in question.

It was the position of the petitioner in the Court below, that there is not a scintilla of evidence to support the disallowances above referred to.

Summary.

The grounds upon which the petitioner relies for this application may be briefly summarized as follows:

1. That the decision of the Circuit Court of Appeals represents an erroneous extension of the rule in *Dobson v. Com'r.* and that accordingly it will be proper for this Court to indicate the true limits of that decision.

2. That question has been raised as to the application of Sec. 10 (e) of the Administrative Procedures Act* which provides that:

“(e) SCOPE OF REVIEW.—So far as necessary to decision and where presented the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of any agency action. It shall (A) compel agency action unlawfully withheld or unreasonably delayed; and (B) *hold unlawful and set aside agency action, findings, and conclusions found to be (1) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; (2) contrary to constitutional right, power, privilege, or immunity; (3) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right; (4) without observance of procedure required by law; (5) unsupported by substantial evidence in any case subject to the requirements of sections 7 and 8 or otherwise reviewed on the record of an agency hearing provided by statute; or (6) unwarranted by the facts to the extent that the facts are subject to trial de novo by the reviewing court. In making the foregoing determinations the court shall review the whole record of such portions thereof as may be cited by a party, and due account shall be taken of the rule of prejudicial error.*” (Italics supplied.)

By reason of the apparent conflict of opinion between the Court below and the decision of the Circuit Court of

* 5 U. S. C. A. 1008 (e).

Appeals of the Sixth Circuit in *Lincoln Electric Co. v. Com'r.*, 164 F. 2d 379, it would be proper for this Court to clarify the applicability of the statute in question.

3. In view of the amendment to Sec. 1141 (a) of the Internal Revenue Code, the Circuit Court of Appeals should be instructed to give effect to its holding in *Kirschenbaum v. Com'r.*, 155 F. 2d, 23.

4. The assessments made herein should be reviewed in the light of possible confiscation of petitioner's property.

POINT I.

That the Court below erroneously limited itself in its review of the determination by the Tax Court so that the Petitioner has in effect been deprived of any real review on the merits.

Since the decision by this Court in *Dobson v. Com'r.*, 320 U. S. 488, the multiplicity of factual situations which arise in tax cases has elicited a variety of expression both from this Court and from the Circuit Courts of Appeals as to the exact extent and nature of the power of review possessed by the Circuit Court of Appeals over the determinations of the Tax Court. It would appear that the basis of all the decisions is an effort to give proper weight to the expert opinions of the members of the Tax Court. However, as this Court said in the *Dobson Case*:

“Its decision of course, must have ‘warrant in the record’ and reasonable basis in law”.

It was the position of the petitioner below as set forth in its brief, in that Court, that in the instant case there is

no "warrant in the record" for the determination of the Tax Court.

It is true that the Court below does not, in so many words, refer to the *Dobson Case*, but, apparently taking an erroneous view of the limitations on its power set by that case, it has completely abdicated its power of review to the detriment of the petitioner.

The Circuit Court of Appeals of the Second Circuit (the Court to which the writ is sought herein), in *Com'r. v. Flushingside Realty Co.*, 149 F. 2nd, 572, in its opinion by Judge Learned Hand, accurately delimits the scope of this power of review:

"So strictly has our review of findings of fact by the Tax Court been confined that it is always with much hesitation that we approach a reversal. Yet *we must have some scrutiny at whatever reserve unless our review is to be limited to a bald examination as to whether the Court has stated enough facts to make a legal foundation for its order.* We should suppose that there might conceivably be constitutional doubts as to such a complete abdication; and up to the present time at any rate, the Supreme Court has not suggested that we must so far abstain. We must assume therefore—the taxpayer having the burden—that if the record is wholly destitute of evidence to support a finding, it is our duty to reverse an order which must rest upon it." (Italics ours.)

It is the contention of the petitioner that the Circuit Court of Appeals has in the present case, entirely ignored this well-considered view of its functions. Petitioner wishes respectfully to call to the attention of this Court that in this case the opinion of the Tax Court and its findings of fact have not, in the language of the quoted opinion, "stated enough facts to make a legal foundation for this

order". All that the Tax Court has to say on the question of its basis for determining the reasonableness of the compensation involved is the single sentence in its opinion (R. 22):

"it may well be that due to the demand for that particular type of goods no sales effort were required to dispose of all of the equipment produced"

and the Circuit Court of Appeals used this single statement to support its affirmance of the Tax Court; this in face of a record showing uncontroverted evidence that virtually all of Capita's time was spent "in sales engineering" (R. 17, 73, 80, 83) and in face of the express finding of fact by the Tax Court that percentages of gross sales in excess of that paid to Capita were usual and reasonable in the industry involved (R. 18). The very language used indicates that the Tax Court was stating an hypothesis, not finding a fact.

The Court below seems to have lost sight of the essential question because it felt that the petitioner's sales engineer *might have exercised* complete control over the petitioner's assets. After all, it is immaterial whether payments at issue here were made to a person who happens to be a stockholder or not. The corporation might properly pay for services rendered. The fact that Capita might ultimately receive whatever remained, by reason of another legal relationship, has no bearing on the reasonableness of the compensation. Since that is so, if the Circuit Court had reviewed the determination of the Tax Court in the light of the uncontroverted evidence referred to above, the fatal defect in that determination would have clearly appeared. As was said in *Lawton v. Com'r.* 164 F 2nd 380, by the Circuit Court of Appeals for the 6th Circuit at page 384:

"We are aware, of course, that the Tax Court is not required at all event, to believe the testimony of witnesses, or even to accept at face value documents offered in evidence, but it appears to be well settled that the fact finder may not arbitrarily disregard undisputed and uncontradicted testimony of unimpeached persons where he has already found facts which lend a flavor of truthfulness to their assertions."

As we have indicated above, the Tax Court merely stated an hypothesis without foundation in fact, by reason of the multiple relation of Capita to the petitioner. The following language of the Court in the *Lawton* case, *supra*, aptly expresses the petitioner's contention:

"It is out of such gossamer threads of circumstance the findings and conclusions of the Tax Court are woven, and it becomes our duty to determine whether the findings and conclusions are based upon substantial evidence as the phrase has repeatedly been defined by the Supreme Court."

Thus the Circuit Court, confronted by a maze of facts actually existing and duly found (which, however, are wholly irrelevant to the point at issue) seems to have lost sight of the fact *that there is no substantial evidence to support the principal finding, i.e., that Capita's services were reasonably worth \$40,000 instead of \$56,000.*

It follows from the foregoing that if the petitioner was given the review to which it is entitled under the *Dobson* case, the Circuit Court of Appeals would have been constrained to reverse the determination of the Tax Court, and at very least remand the matter to that Court for further proceedings.

Since the Circuit Court of Appeals has erroneously divested itself of its function of review, this Court should

again enunciate the correct principle and grant the petitioner the relief to which it is entitled.

As this Court said in *Bingham's Trust v. Com'r*, 325 U. S. 365:

"Hence the statute does not leave the Tax Court as the final arbiter of the issue whether its own decisions of questions of law are right or wrong. That can only be ascertained upon resort to the prescribed Appellate process by a consideration of the merits of the point of law involved and by its decision at the conclusion of the process, not before it begins."

POINT II.

That the scope of review possessed by the Circuit Court of Appeals has been enlarged by the Administrative Procedures Act.

Question has been raised as to the exact effect of Sec. 10 (e) of the Administrative Procedures Act upon the reviewability of determinations of the Tax Court. No reference is made in the opinion below to any possible extension of the power of review by that statute, but the Court apparently felt that the power of review was not extended. On the other hand, in *Lincoln Electric Co. v. Com'r*, 164 F. 2d 379, the Circuit Court of Appeals for the Sixth Circuit, gave voice to the opinion that the effect of the statute is to render the determination of the Tax Court subject to a broader review than had been true under the *Dobson* rule. By reason of the diversity of opinion existing among the Circuits it is proper that the decision of the Circuit Court of Appeals in this case be reviewed in the light of applicability of that statute and that this Court give concrete expression to the controlling legal principle.

The Circuit Court should be instructed that it has the power under that statute and that it should exercise that power in this case to set aside the findings and conclusions of the Tax Court as unsupported by substantial evidence and that it should review the whole record and take due account of the rule of prejudicial error.

The petitioner in its brief below argued for the position just stated. In view of the fact that the Circuit Court's opinion is wholly silent on this point, it cannot be said with certainty that account was taken by that Court of the possible effect of the statute and it is respectfully requested that this Court remove the confusion existing.

POINT III.

The amendment to Sec. 1141(a) of the Internal Revenue Code entitles the petitioner to a complete review.

An anomalous situation has heretofore existed in the Second Circuit as a result of the holding of the Court in *Kirschenbaum v. Com'r*, 155 F. 2d 23 (cert. den. 329 U. S. 726), in which the Court held that a determination of the Tax Court as to the effect of a purchase of treasury stock was not reviewable but, at the same time, explicitly reaffirmed a contrary rule for appeals from the District Court.

So, here, there can be no doubt that if the instant case had come to the Circuit Court on appeal from a decision of the District Court, the Circuit Court of Appeals would have had no hesitation in reviewing the record, and free from any artificial restraint must inevitably have seen the want of foundation for the finding of the lower Court.

But the effect of the recently enacted amendment to Sec. 1141 (a) of the Internal Revenue Code is precisely to relieve the Court of that restraint, since it provides that decisions of the Tax Court shall be reviewable to the same extent as decisions of the District Court in non-jury cases.

The effect of this statute is primarily a change in procedure and substantial justice will be effectuated by a direction to the Circuit Court of Appeals to apply the statute to the instant case, and to proceed accordingly.

POINT IV.

The assessments levied in this case are confiscatory and involve an unlawful taking of the Petitioner's property.

As appears from the tables submitted as Appendix "A" hereof, the taxes and assessments, with interest, levied against the petitioner total \$47,061.94, or, 119% of the net earnings of the petitioner for the tax year in question; this latter amount was \$41,274.25.

As appears from the second table attached, the additional assessments were reduced by the Tax Court from \$22,273.30 to \$12,971.70. In effecting this reduction it was necessary for the petitioner to make additional expenditures for legal fees. The propriety of such payment is clearly evidenced by the fact that such expenditures resulted in the saving above indicated. When both the saving and the legal fees are taken into consideration, the corporation's expenditures in connection with these taxes total \$45,137.08. This amount exceeds 109% of the corporation's net earnings.

While it is quite true that the computation of the net earnings above referred to reflects the \$56,000.00 payment

which is sought to be allowed herein, the fact remains that that amount was actually paid in good faith and is not capable of being recouped.

The inevitable result of this process is that the petitioner's capital is being confiscated by the Tax authorities.

The petitioner would like, in addition, respectfully to bring to the attention of this Court, that the delay by the Commissioner in making this assessment (a period of upwards of three years) has resulted in an additional burden of interest. Such delay is perhaps unavoidable, but there is no reason why the petitioner should suffer detriment by reason thereof.

That this Court should review the determination of the Circuit Court of Appeals and remand the proceedings herein for proper review in accordance with law.

Respectfully submitted,

The Firm of
MR. AND MRS. EVERETT FROOKS,
Office & P. O. Address,
30 Vesey Street,
Borough of Manhattan,
City and State of New York.

EVERETT FROOKS,
JOSEPH P. DOWLING,
MARGARET FROOKS,
Of Counsel.

APPENDIX A.

Actual Figures for 1941—Based on Commissioner's Decision

Gross Sales (1941).....		\$222,346.65
Less cost of manufacturing and operating expenses and before deducting selling commissions.....		116,288.08
		<u>\$106,058.57</u>
Less Selling Commissions:		
Paid E. R. Capita, Sales Engineer..	\$56,000.00	
Paid sales agents.....	8,784.32	64,784.32
		<u>\$ 41,274.25</u>
Net earnings for 1941.....		
Federal taxes paid.....	\$20,779.45	
Additional assessments as adjusted by Tax Agent	22,273.30	
Interest on assessments.....	4,009.19	
		<u> </u>
Amount demanded by tax collector for 1941 operations	\$47,061.94	

Thus, the Tax Collector's assessment is 114% of net income for the taxable year.

Actual Figures for 1941—Based on Tax Court Decision

Gross Sales (1941).....		\$222,346.65
Less cost of manufacturing and operating expenses and before deducting selling commissions.....		116,288.08
		<u>\$106,058.57</u>
Less Selling Commissions:		
Paid E. R. Capita, Sales Engineer..	\$56,000.00	
Paid sales agents.....	8,784.32	64,784.32
		<u>\$ 41,274.25</u>
Net earnings for 1941.....		
Federal taxes paid.....	\$20,779.45	
Additional assessments as per tax court ruling	12,971.70	
Interest on assessments to July 22, 1948..	4,907.63	
Legal fees paid up to December 31, 1947 in connection with tax case.....	6,478.30	
		<u> </u>
Actual Corporation expenses.....	\$45,137.08	

Thus, \$45,137.08 represents the actual Federal taxes, additional assessments, interest thereon and legal fees totalling over 109.6% of the Corporation's net earnings.